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SUBJECT: SRI LANKA: IMF CONCERNED ABOUT ECONOMIC POLICY

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¶1. (SBU) SUMMARY: During a meeting with Econoffs, IMF officials visiting Sri Lanka for "Article IV" consultations privately expressed concerns about Sri Lanka's persistently high inflation, various fiscal problems, and external imbalances. Taken together, these signs from the Sri Lankan economy are troubling and may have a negative impact on the country's traditionally high long- term growth rates. The IMF team predicted that fiscal and monetary adjustments will be necessary to avoid a future economic crisis. However, based on the Central Bank's public announcements, the government would appear to be in no hurry to heed the IMF's advice. END SUMMARY.

REIN IN HIGH INFLATION, FISCAL
SPENDING AND EXTERNAL IMBALANCE

¶2. (SBU) On August 19 and 22, Econoffs met with a visiting IMF Article IV mission in Sri Lanka. IMF officials visited Sri Lanka in late August to gather information for an annual report on the country's macroeconomic situation. The final summary report will be shared with the GSL for comment prior to its release in early November 2008. The IMF team noted at the outset that concerns about security in connection to the ongoing conflict between the government and the LTTE is one of the key risks for Sri Lanka's future growth potential. They identified several vulnerabilities in the Sri Lankan economy, including persistently high inflation, fiscal weakness, and external imbalances. Sri Lanka also remains exposed to the global economic slowdown and high oil prices.

WATCH OUT FOR FISCAL FISSURES

¶3. (SBU) Overall, the IMF predicts Sri Lanka's economy will continue to grow and assessed that a recession is highly unlikely in the near future. That said, the IMF team outlined several areas of concern in the macroeconomy. They are worried about persistently high inflation - currently running over 26 percent according to official figures that likely understate inflation - and the prospect of a wage-price spiral. Another major area of concern is the high fiscal deficit, largely driven by mounting debt service costs.

¶4. (SBU) Public debt continues to remain high, around 86 percent of GDP, with a large amount of debt maturing in 2009. The IMF team criticized recent GSL moves towards external short-term borrowing. In a bid to expand the domestic bond market to non-captive sources, the government has encouraged foreign investment in treasury bills/bonds, but this has shortened the maturity structure of debt and exposed Sri Lanka to external shocks (ref B).

¶5. (SBU) In addition, the government's fiscal flexibility is further restrained due to a huge government wage/pension bill and defense expenditure. According to the IMF, even though the GSL has done better than nearly all South Asian economies in passing on higher oil prices onto consumers and reducing subsidies, more determined fiscal consolidation and revenue generation will be essential for debt management. However, in meetings with the IMF team, the GSL officials seem to think otherwise, stressing that necessary adjustments have already been taken and no further action is required.

GUARD AGAINST A GROWING
CURRENT ACCOUNT DEFICIT

¶6. (SBU) On the external economic front, the IMF team outlined several key challenges and voiced pessimism about sustained long-term growth. The current account deficit is widening with the trade deficit reaching a massive $3 billion in the first half of 2008 as compared to $1.6 billion in the first half of 2007. The primary reason for the growing trade deficit is the high expenditure on imports such as oil, food, building materials and machinery.

¶7. (SBU) While imports have increased by 36 percent this year, exports have grown only by 10 percent. Over the same period, the oil bill has almost doubled, from $958 million to $1.8 billion. On the export front, prospects for garments, Sri Lanka's largest export which accounts for 37 percent of industrial output and comprises 4 percent of GDP, are weakening. Tea and rubber exports have been the only saving grace, noted the IMF team, because of the global commodity price boom. Although foreign remittances continue to be

strong at $1.4 billion in the first half of 2008, thanks to increasing numbers of Sri Lankans working overseas (ref A), the magnitude of the trade deficit implies a strain on the current account. The extent of the trade deficit also raises concerns about Sri Lanka's foreign currency reserves: according to IMF estimates, official reserves amount only to approximately 2.5 months of imports.

THINK TWICE ABOUT
INFLATING THE RUPEE

¶8. (SBU) The IMF is concerned about the exchange rate peg to the U.S. dollar, noting that the Sri Lankan rupee (SLR) is over-valued. Despite high inflation and the growing current account deficit, the Central Bank has maintained a soft peg at approximately SLR 108 to one USD in 2008, keeping the SLR artificially inflated. During 2007, the rupee depreciated to about SLR 114:USD 1 before the government floated the first sovereign bond issue and increased short-term borrowing. GSL moves to finance the current account deficit by attracting short-term capital inflows have helped the Central Bank maintain the peg thus far in 2008. Moreover, Sri Lanka has also postponed currency adjustment by purchasing oil on credit terms from Iran. The IMF team speculated that the state of the Sri Lankan economy may prevent the GSL from successfully maintaining the soft peg over the longer term.

CENTRAL BANK REMAINS CONFIDENT
DESPITE IMF CONCERNS

¶9. (SBU) Despite these concerns, IMF officials commented that none of these developments seem to worry the Central Bank. Instead, the bank has been actively defending its exchange rate and external financing policies in recent months. For example, on August 15, Central Bank officials claimed that the balance of payments is in surplus, partly due to higher foreign financial inflows. In another announcement, the bank also asserted that interest rates on government bills had begun to ease due to foreign financial inflows.

¶10. (SBU) The Central Bank has also stated the SLR would have appreciated more sharply due to financial inflows if not for its

intervention in the market. In early July, at an economic summit organized by the Ceylon Chamber of, the Central Bank Governor argued against currency depreciation. He said the SLR decline had expanded the foreign debt stock and the time was ripe to change the exchange rate policy. He warned the business sector not to expect a depreciating SLR as it seeks to remain competitive. According to the IMF, both the government and the business sector are also bullish about an impending peace dividend or ceasefire between the government and LTTE which would allow Sri Lanka to defer difficult financial adjustments.

¶11. (SBU) The IMF team told us that many of their GSL interlocutors assured them that government forces were well on the way to eliminating the LTTE and ending the conflict within the next several months. GSL officials, it said, appeared to be banking on a "peace dividend" that would resolve the lion's share of whatever economic problems Sri Lanka may be facing currently.

ROADMAP TO AVOID ECONOMIC CRISIS

¶12. (SBU) COMMENT: While the Sri Lankan economy overall appears headed for continued growth, though at lower rates than in years past, the IMF review highlighted important areas of concern. In the near-term, the IMF's concerns, which are also shared by a senior economist at the Ceylon Chamber of Commerce, will have a limited impact on this year's growth figures. Sri Lanka is not headed for a recession but medium-term economic prospects depend critically on the pace of fiscal consolidation, policy adjustments to reduce external risks, and peace between the government and LTTE. The GSL and Central Bank appear to be ignoring alarm bells to reduce inflation and step up their efforts to tighten macroeconomic policies. Thus far, Sri Lanka has been able to manage by relying on foreign commercial borrowings but for long-term, sustained growth, the GSL will have to improve economic fundamentals that encourage investment. While an end to the conflict would likely result in some sort of peace dividend, the GSL's inability to produce a realistic proposal for a political solution means that there is little chance for real peace in Sri Lanka in the medium term. We

share the concern of the IMF and other observers that a genuine improvement in Sri Lanka's economic fundamentals would come via policies that encourage investment, rather than simply by eliminating the Tamil Tigers as a conventional military force.

BLAKE